THE WISCONSIN TAX DECISIONS OF JUNE, 1906.

During the session of 1905–06 the Wisconsin Supreme Court handed down three decisions,[1] all dealing with taxation and all delivered on the same day, which contain so many legal interpretations of interest to economists that they deserve somewhat extended notice.

The arguments in all these cases centred around section 1, article 8, of the Constitution of Wisconsin, which declares that "the rule of taxation shall be uniform, and taxes shall be levied on such property as the legislature shall prescribe." For more than fifty years nobody has known what this provision of the constitution really means. Many eminent authorities have held that under it the Wisconsin legislature could levy practically nothing but proportional property taxes; others have maintained that the legislature could levy other kinds of taxes, but that in any case the rate must be proportional; whilst the most liberal interpreters have held that the legislature could impose any of the ordinary commonwealth taxes, and in each tax could exercise the right of reasonable classification with respect to form and rates which the decisions of the federal courts have made familiar.

This irritating uncertainty has finally been removed by the decisions under consideration. The Supreme Court took a position midway between the two extremes, but made its position perfectly clear. The legislature is not confined to taxes upon property, but may employ privilege, occupation, poll, excise, license, inheritance, and other taxes customarily used by American Commonwealths. Property taxes, however, must be uniform and propor-

[1] Chicago & Northwestern R.R. Co. *et al.* *v.* State, State *v.* Chicago & Northwestern R.R. Co. *et al.*, and Nunnemacher *v.* State, all of which may be found in the *Northwestern Reporter*, vol. 108, to which all page references not otherwise designated refer.

tional, altho this obligation of uniformity refers to essence and substantial burden, not to form and incident. With respect to other taxes—those not referred to in the constitutional clause cited—the legislature has wider discretion, and may vary the rate as well as the form, subject only to the limitations of the doctrine of reasonable classification. This unequivocal interpretation of the constitution brings a grateful sense of relief to the people of Wisconsin. Previous opinions have been so obscure and in some instances so narrow in spirit that recently, when a group of advanced legislators wished to introduce an income tax in Wisconsin, they wasted no time in attempting to pass a statute, but submitted the question directly to the people in the form of a constitutional amendment.

I. The first group of cases cited above, the "penalty cases," grew out of the attempt of the State to collect certain penalties for false or wrongful reports of gross receipts, upon which basis, it will be remembered, Wisconsin railroads were taxed until 1903, when the gross receipts tax was replaced by the so-called ad valorem tax. In May, 1903, the administration determined, in Governor La Follette's words, "to ascertain, if possible, whether the State had been wronged by the railroad companies in the amounts which they had been reporting annually as the sum of their gross earnings for taxation."[1] This investigation resulted in the discovery of what seems to be incontrovertible evidence of unlawful discrimination among competing shippers, in addition to very considerable charges and accounts which had been wrongfully withheld from the statements of gross receipts made by the railroads for purposes of taxation.[2] At the time of this last report the investigation of the railroad commissioner had covered the accounts and vouchers of nearly all the railroads of the State for the years 1897–1903, and in the case of three of the larger roads had been carried back to the year 1894. The railroad commissioner's

[1] Message of Governor Robert M. La Follette to the Wisconsin legislature, May 16, 1905.

[2] See Special Reports of Railroad Commissioner John W. Thomas, March 23, 1905, and July 6, 1906.

recapitulation of the amounts which, it is alleged, were wrongfully treated by the railroads in their reports is given immediately below, and will serve to call attention to the general character of the items concerning whose inclusion among gross receipts the difference of opinion exists:—

AMOUNTS DEDUCTED FROM GROSS EARNINGS BEFORE REPORT FOR TAXES.

Commissions and repayments to shippers	$6,856,988.75
Commissions and repayments on passenger traffic	872,661.70
Expense of operating hotels	1,600.96
Expense of operating sleeping cars	13,728.91
By refunds to shippers from Kansas City and Omaha to Chicago, on freight which never entered the State and no part of which was credited to the State	47,008.46

AMOUNTS NOT REPORTED FOR TAXES THAT ARE A PART OF GROSS EARNINGS.

Car mileage, credit balance	$1,070,856.11
Switching charges collected	2,314,309.02
Storage, demurrage, and miscellaneous	165,304.09
Rentals of tracks and terminals	905,684.48
Total	$12,248,142.48

What proportion of the commissions and rebates unearthed in the investigation actually constituted unlawful discriminations, and what proportion of the above amounts were, in the proper interpretation, wrongfully deducted or omitted from the statement of gross receipts, are undecided questions which, in justice to the railroads, should not be prejudged. This much may be said, however. The case under discussion was argued and adjudicated on the basis of certain stipulations as to the facts upon which both parties agreed. In the first of these stipulations the railroads admitted that certain earnings had been omitted from their statements of gross receipts, and that "some of the items so omitted from said statement constituting of themselves a substantial sum were, in fact, gross earnings." On the other hand, the railroads contended, and the State in turn acquiesced in the contention, that, in withholding

such earnings from their statements of gross receipts, the officers of the railroads had "acted and relied upon advice of counsel learned in the law, to the effect that the items so omitted did not constitute gross earnings under the statute: which advice they believed."

The penalty cases, which were decided in favor of the railroads, turned upon the stipulation last mentioned. The court held that, as the State had never furnished any clear definition of "gross receipts," and as experience demonstrates that it is a difficult matter to decide what should be covered by that term, the railroads ought not to be penalized for omitting, in good faith and on the advice of counsel, doubtful items. In arriving at this decision, however, the court encountered one great difficulty. Penalties for failure to pay ordinary taxes are, according to the best law, very rigorously enforced, no attention being paid to the reason for non-payment, whether the fault be excusable or inexcusable. This the court recognized fully. The difficulty was avoided by construing the license tax as a contractual obligation rather than a tax in the narrow sense, punitive provisions of contracts being much more liberally construed than similar provisions of tax laws. "The taxing law, so called, under consideration . . . involved, in legal effect, an exchange between the State and the railroad company of equivalents. The former accords the latter the privilege to operate its roads: the latter, in consideration thereof, renders to the former a proportion of its earnings" (p. 608). Later the court went into an analysis of the gross receipts license fee, deciding that, while in one sense a tax, it is in another sense a mere *quid pro quo*,— "an exaction referable to the taxing power, with the contractual element, however, specializing it."

While penalties are, therefore, not to be collected, it is probable the State will eventually secure the back taxes due on the amounts wrongfully withheld from the statements of gross earnings. The decision practically intimates that it is the duty of the State to bring action for the recovery of such taxes.

II. The ad valorem tax on railroads, which has been in force since 1903, provides that railroads shall be assessed at full value by the State tax commission, and that on this assessed valuation they shall be taxed at the average rate of taxation paid by other property in the State. This average rate of taxation is arrived at by dividing the total property tax collected in the State by the true (as distinguished from the assessed) value of all property subject to the property tax. The railroad taxes, it may be said further, are retained by the State, and no portion is distributed back to the municipal or county governments.

With this brief description of the nature of the tax, we may proceed to summarize briefly the more important points decided in this second group of "ad valorem cases."

(1) One of the strongest arguments, if not the strongest argument, made by the railroad attorneys, rested upon the fact, which they proved by the evidence of many assessors, that in the valuation of ordinary business concerns, including commercial and manufacturing corporations, no separate account was taken of good will, value of business organization, and the like, while these elements were given full weight in the assessment of railroads. The railroads contended, in short, that, if all the intangible elements of ordinary business concerns had been assessed as completely as they were assessed in the case of railroads, the value of the general property of the State would have been very much greater than the amount fixed by the tax commission, and that the rate of taxation upon the railroads would have been correspondingly lower.

In rejecting this argument, the Supreme Court set up a rather remarkable doctrine of value and valuation. In brief, the court denied that it is possible, either in the case of private businesses, ordinary corporations, or quasi-public corporations, to assess the physical value of the property separately from the intangible value given by the good will, favorable prospects, or actual franchises.

> The statute does not contemplate that franchises of any sort of corporations, private or public, or good will or prospects of any busi-

ness or any such matters, shall be considered by the assessor and valued as separate elements or that any definite sum shall be added to the value of the physical things on account thereof. It only contemplates the valuation of such physical things under the circumstances of each particular case. The value of the physical elements of corporations, or business property, is made up largely of those which are invisible. . . . In valuing such property, looking only at the visible elements, one would unconsciously include the invisible. No one would think, in valuing a factory of any sort with an established business, of its value as a disorganized piece of property. . . . To our minds, when the witnesses [the assessors] on the trial of this case stated they valued the property of business corporations or companies, observing only the things visible, fixing the value upon those things as they found them, whether they specially thought of the other elements and considered the same or not, they were in effect included (p. 572). . . . One might as well try to value the life blood of a horse or his capacity to breathe as to try to place a value upon the visible part of a railroad property separate from its rights, franchises, and privileges (p. 573).

(2) Ad valorem taxation of railroads at the average rate of taxation paid by other property raises a nice question concerning the exact content of the group of things which are glibly designated by the phrase "general property of the State." When dividing the total property taxes by the true value of general property in order to ascertain the average rate of taxation, should property which has wholly escaped taxation be included or not? In other words, should railroads be taxed at the average rate paid by other property which is "caught," or at the average rate paid by those tax-payers who are "caught," or at the average rate which would obtain if all taxable property and all tax-payers were properly assessed and taxed?

The railroads contended that the tax commission had not made sufficient allowance for such omissions, altho both the law and the arguments were obscure concerning the precise duty of the commission in this respect. As a matter of fact, the commission had made allowance for omitted and undervalued property, and the Supreme Court found that no evidence adduced by the railroad attorneys destroyed the presumption in favor of the commission's computations as they had actually been made. On the contrary,

the court suggested that possibly the tax commission had exceeded its authority in making allowances for property omitted by local assessors.

> The board [tax commission] in endeavoring, as before indicated, to remedy the supposed mistakes of the local assessors as to omitting to assess property at all, perhaps assumed authority not clearly accorded to it. However, there is no proof that such omissions, if there were any, occurred otherwise than as the result of mere ignorance or error of judgment in a good faith attempt to administer valid laws. Such circumstances afford no good ground for complaint on the part of a tax-payer to avoid his tax (p. 575).

(3) In Wisconsin, at the present time, mortgages on real estate are taxed according to the Massachusetts method; *i.e.*, a mortgage is declared to be, for purposes of taxation, an interest in the realty by which it is secured, and the mortgagor and mortgagee are permitted to arrange between themselves who shall pay the tax. If no such arrangement is made, the tax must be paid by the mortgagee. The railroads rested one of their principal arguments upon the fact that in this connection they were not accorded the same privileges as other mortgagors, and that "no diminution of the value of railroad property could be or was made . . . because of encumbrances thereon of a mortgage nature." The court overruled this plea on the general ground that differentiation between railroads and other mortgagors is reasonable classification, and hence not repugnant to the equality provisions of the Wisconsin and federal Constitutions. According to sound economics, and, in particular, according to the views of the Wisconsin courts concerning the nature of railroad property (which is treated as predominantly personal), railroad bonds are mortgages rather upon personalty than upon realty; and mortgages secured by personal property in Wisconsin are not taxed as an interest in the personalty. Moreover, there are other fundamental differences between railroad bonds and real estate mortgages.

> Railroad mortgages, so-called, are, as a rule, trust deeds, securing millions of dollars in bonds distributed through a wide extent of

country, and, in many cases, among people in many countries, the owners in the aggregate numbering up into the thousands. It is easily seen that to apply such a law as the one in question to such a situation, requiring each bondholder to be regarded as the owner of so much value in railroad property as his bonds called for, and to tax him accordingly, would be more than impracticable, it would be impossible as regards producing any real beneficial effects (p. 583).

(4) From what has been said above, it is apparent that the rate of taxation upon railroads is affected by the property taxes collected in every taxing district of the State, altho there are many towns and villages which the railroads do not reach. The railroads attacked the law vigorously at this point, maintaining that it gives "special property a general situs," and makes their burden of taxation dependent upon the expenditures of jurisdictions in which they possess no property and from which they receive no benefits. In rejecting this argument, the court acknowledged that it was not within the power of the legislature to give a capricious or arbitrary situs to property for purposes of taxation, but held that the commanding position of railroad corporations,

> the universality and closeness of their touch with the every-day life of the people, the mutual relations of dependence for well-being both as to persons and property, reaching the State at large, the needs of such corporations as to support and protection, the significant degree in which the administrative energy of all departments of the State is devoted to affairs concerning their regulation and well-being, and their public privileges springing from the whole people, warrant the exercise of legislative power, giving to their property for the purposes of taxation a general situs, and applying thereto the average rate of taxation throughout the State. . . . (p. 559).

Moreover, the court held that the local districts are not in a practical sense deprived of revenue to which they are justly entitled. The tax on railroad property retained by the State government enables the latter to dispense almost entirely with the levy of ordinary property taxes, and by a theory of "constructive accounting" the tax on railroad property may be regarded as equivalent to property taxes which the State would be compelled to collect from the

local governments if the latter were permitted to tax railroad property. This theory of "constructive accounting," like the court's doctrine of the impossibility of disassociating tangible from intangible values, will bear a good deal of study.

III. The case of Nunnemacher *v.* State brought once more before the courts the constitutionality of progressive inheritance taxation in Wisconsin. An earlier inheritance tax had been declared unconstitutional by the Supreme Court because the rates were graduated in accordance with the value of the entire estate, and not in accordance with the value of the separate shares.[1] In 1903, however, the legislature passed another law (ch. 44, p. 65, Laws of 1903) in which the rates were graduated according to the relationship of the beneficiary of the decedent and the size of the particular legacy or inheritance.[2] The law was sustained by the court, altho it is highly progressive, the rate reaching practically 15 per cent. upon shares in excess of $500,000 passing to very distant relatives or strangers.

Progressive inheritance taxes have now been sustained in so many States, and the grounds upon which such approval rests are so generally understood, that the Wisconsin case deserves no special notice except for its vigorous repudiation of the principal theory upon which the decisions in most other States have been based. To put the matter briefly, the tax was attacked upon the ground that "the right to take property by inheritance or by will is a natural right protected by the constitution, which cannot be wholly taken away or substantially impaired by the legislature." The validity of this general argument was emphatically affirmed by the court. None the less, the law was sustained upon the ground that the particular inheritance tax in question does not annul or substantially impair the constitutional right to take property by will or inheritance.

The doctrine laid down by the Wisconsin court has a familiar tone. Our government is the "product of a social

[1] Black *v.* State, 113 Wis. 205.

[2] See the account of this act in the article by Dr. S. Huebner in this *Journal*, vol. xviii. pp. 540–541 (August, 1904).

compact," adopted to preserve and maintain inherent rights existing prior to and independent of all government. And among these fundamental rights must be numbered the right to dispose of property by will.

The biblical writings show the exercise of the right from the times of Abraham, and Mr. Schouler in his book on Wills (2nd Ed.), § 13, says that history "confirms the opinion that the practice of allowing the owner of property to direct its destination after his death, at least of imposing general rules of inheritance, is coeval with civilization itself, and so close, in fact, upon the origin of property and property rights as not to be essentially separated in point of antiquity.". . . So clear does it seem to us from the historical point of view that the right to take property by inheritance or will has existed in some form from the time when the memory of man runneth not to the contrary, and so conclusive seems the argument that these rights are a part of the inherent rights which governments, under our conception, are established to conserve, that we feel entirely justified in rejecting the dictum so frequently asserted by such a vast array of courts, that these rights are purely statutory and may be wholly taken away by the legislature. It is true that these rights are subject to reasonable regulation by the legislature, lines of descent may be prescribed, the persons who may take as heirs or devisees may be limited, collateral relations may, doubtless, be included or cut off, the manner of execution of wills may be prescribed, and there may be much room for legislative action in determining how much property shall be exempted entirely from the power to will so that dependents may not be entirely cut off. These are all matters within the field of regulation. The fact that these powers exist and have been universally exercised affords no ground for claiming that the legislature may abolish both inheritance and wills, turn every fee-simple title into an estate for life, and thus, in effect, confiscate the property of the people once every generation (pp. 629, 630).

The tax, in short, was justified because the legislature has a right *reasonably* to regulate and tax transfers of property, and not because, as the Supreme Court of the United States has said, "the right to take property by devise or descent is the creature of [positive] law." "We are fully aware," says the Wisconsin court, "that the contrary proposition has been stated by the great majority of courts of this country, including the Supreme Court of the United States. The unanimity with which it is stated is

perhaps only equalled by the paucity of reasoning with which it is supported" (p. 628).

In Wisconsin, hereafter, inheritance taxes must be reasonable as judged by the economic and political philosophy of the courts. This decision takes from the legislature another power, whose exercise, it has hitherto been thought, was committed to its discretion and wisdom, and places it among the powers which must be exercised hereafter in final conformity with the discretion and wisdom of the judiciary. The decision may shock the economist. But it is hard to resist the reasoning of the Wisconsin court. It may be unfortunate that ours is a government of restricted powers, and that the final decision as to the extent of those powers rests with the judiciary rather than the legislature. But, admitting the legal necessity for a group of constitutional rights to life, liberty, and property, it seems impossible logically to exclude from that group the right to will property in a reasonable way, with its complementary right of receiving property by will or bequest.

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